

DEFENSE SCIENCE
BOARD
RECOMMENDATIONS

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Defense Procurement

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DSB Recommendations

- Profit policy changes
- Progress payment rate changes
- Share savings with industry

Profit Policy Application

Used to develop prenegotiation profit objectives when --

- Contract is sole-source
- Modification of competitively awarded contract
- Value exceeds \$500,000
- Cost analysis used to price contract or modification

Most commonly used on --

- Firm-fixed-price manufacturing contracts
- Cost-plus-fixed-fee R&D contracts

Current Profit Factors

Three areas evaluated --

1. Performance risk - weighted average of three sub- factors:
 - Technical risk
 - Management
 - Cost control
 2. Contract type risk
 3. Facilities capital employed
- (Plus minor working capital adjustment on contracts with progress payments)

Section 813 Changes

- Performance risk changed to two sub-factors
 - Technical risk
 - Management/Cost control
- Technological innovation incentive range added
 - Up to 4% additional for technical risk
 - Subjective evaluation criteria
 - Tied to amount of innovation and value to contract/program

Anticipated DSB Recommendations

- Include IR&D expense in cost base
- Reduce reward for facilities investment
- Add a special factor for cost efficiency
- Reduce incentive to make rather than buy

Proposed Immediate Policy Changes

- Add G&A to cost base
 - Increases profit objective by 3/4%
- Reduce the facilities investment weighting by 50%
 - Reduces profit objective by 1.14%
 - Reduces incentive to make rather than buy
- Offsets to Performance Risk (+1%) and Contract Type Risk (-.5%) maintain revenue neutral bottom line effect
- Special “Cost Efficiency” factor
 - Up to 4% of estimated costs

Proposed Longer-Term Policy Changes

Elimination of Facilities Investment as Factor

- In two years - eliminate buildings and reduce equipment factor by 50%
- In four years, eliminate equipment
- After four years, no consideration of facilities investment in profit policy
- Reductions offset by increases to performance risk
 - 1% at each step
- Revenue neutral
- Provides “advance notice” to contractors of policy change, and ample time to divest

Impact of Policy Changes *

Manufacturing

<i>Markup Category</i>	<i>95-97 Avg</i>	<i>Revised Policy</i>
Performance Risk	4.56%	6.06%
Contract Type Risk	2.56%	2.34%
Working Capital Adjustment	1.72%	1.72%
Facilities Capital Employed:		
Buildings	0.72%	0.24%
Equipment	2.03%	1.15%
Facilities Capital Cost of Money	0.75%	0.75%
Total	12.34%	12.24%

Research and Development

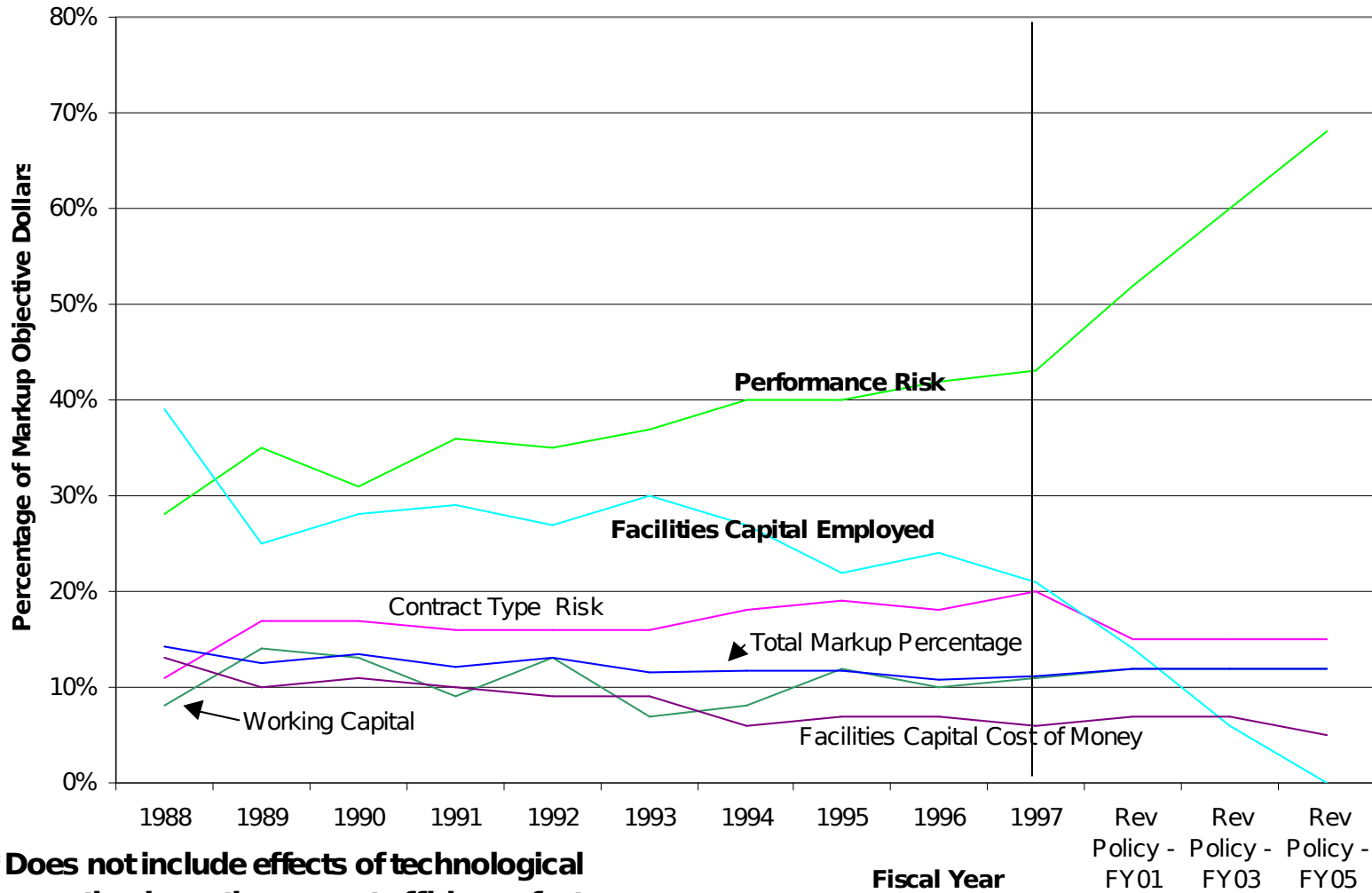
<i>Markup Category</i>	<i>95-97 Avg</i>	<i>Revised Policy</i>
Performance Risk	4.79%	6.37%
Contract Type Risk	0.71%	0.29%
Working Capital Adjustment	0.09%	0.08%
Facilities Capital Employed:		
Buildings	0.48%	0.20%
Equipment	1.33%	0.96%
Facilities Capital Cost of Money	0.70%	0.70%
Total	8.10%	8.60%

Services

<i>Markup Category</i>	<i>95-97 Avg</i>	<i>Revised Policy</i>
Performance Risk	4.99%	6.50%
Contract Type Risk	1.60%	1.25%
Working Capital Adjustment	0.16%	0.16%
Facilities Capital Employed:		
Buildings	0.45%	0.19%
Equipment	1.52%	1.06%
Facilities Capital Cost of Money	0.69%	0.69%
Total	9.41%	9.85%

*** Does not include effects of technological innovation incentive or cost efficiency factor**

Markup Objective Distribution by Dollars *



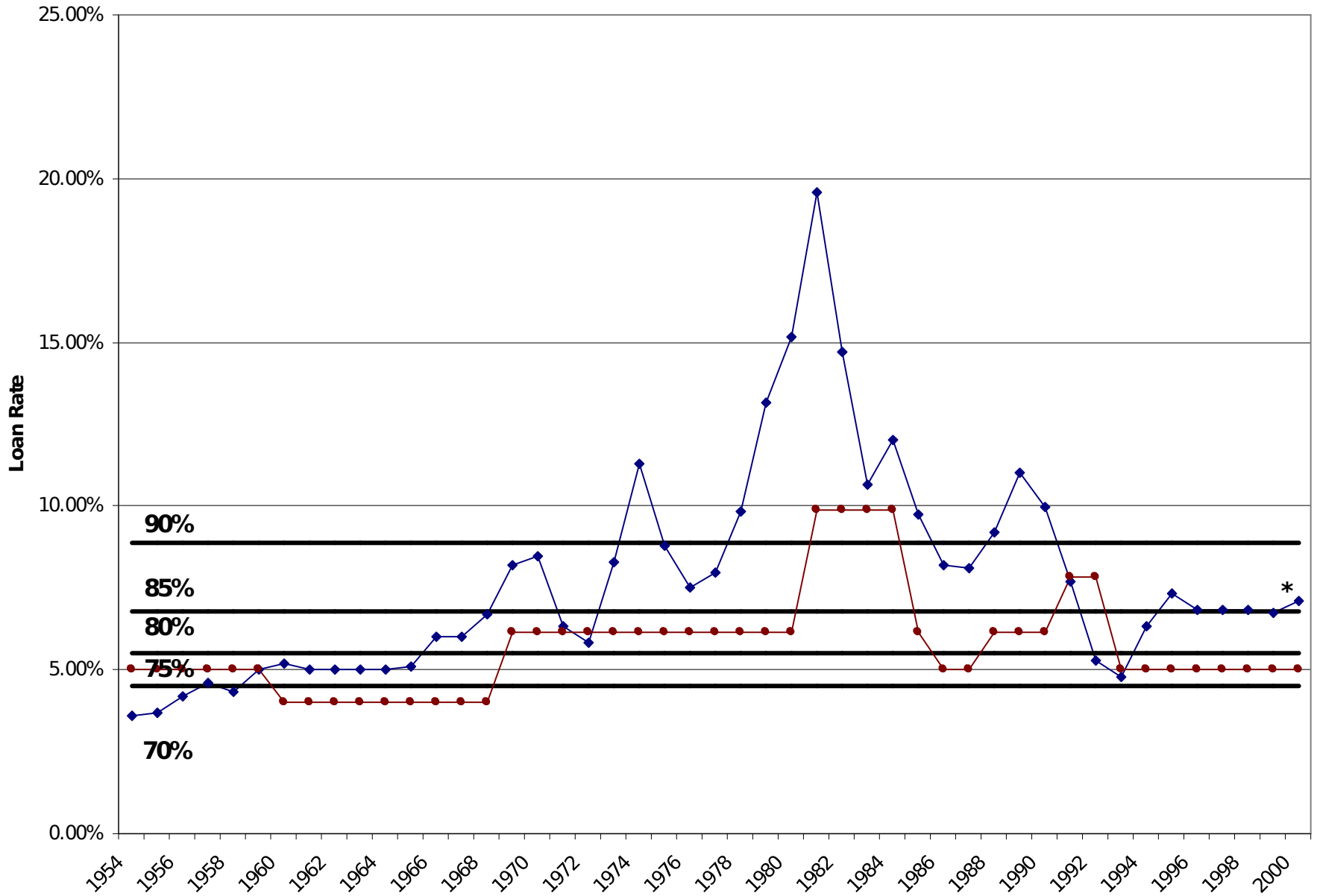
Policy Implementation

- Revisions to Defense FAR Supplement prepared
- DAR Council reviews/edits
- OMB clearance required
- Publication for public comment in Federal Register
- Target for implementation - October 1, 2000
- Leadership message

Progress Payment Rate Changes

- Return to 1991 interest rate-based progress payment guidelines
- Would set rates at 85% for large businesses
- Would apply to new contracts
- Substantial impact on DoD outlays

Progress Payment Rates Indexed to Loan Rates



* Average of last three quarters of 1999 plus first quarter of 2000

Share Savings with Industry

- Provide incentives to cut costs and reward companies that achieve significant savings
- Consider using the value engineering model where appropriate